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November 15, 2005

AGENDA ITEM 8

TO: MEMBERS OF THE HEALTH BENEFITS COMMITTEE

I. SUBJECT: Board's Administrative Decision on GASB 43 and 45 - Consideration of Pre-funding Retiree Medical Benefits

II. PROGRAM: Health, Investments, and Actuarial Services

III. RECOMMENDATION:

The Committee direct staff to (1) seek a funding source which will provide the necessary appropriation of funds to implement any of the three business models contained in this agenda item, and (2) direct staff to finalize an implementation plan for each business model.

IV. ANALYSIS:

During the July 2005 Board Offsite, staff presented to the Board three different business models that are possible under Governmental Accounting Standards Board (GASB) Statements 43 and 45 which pertain to pre-funding retiree medical benefits. These business models as well as other information provided to the Board in July 2005, is contained in this agenda item. As a result of the presentation, the Board directed staff to (1) complete a survey of local government to seek their views on pre-funding retiree medical costs and, (2) complete a legal review on paying the costs associated with implementing any of the three business models. That work has been completed and the survey results are included in this agenda item while the legal review has been submitted to the Board under separate cover.

While the work requested by the Board has been completed, numerous issues remain outstanding before the Board can decide which business model is the right business model. Listed below are a few of those major issues:

- Should CalPERS decide to do the full service model of pre-funding retiree medical benefits, how does CalPERS ensure itself that employers will participate?

- If one of the models is implemented and a few employers participate in year 1 and others follow in future years, how are the start-up costs allocated?

- Once an employer contributes funds to CalPERS, can the employer remove those funds at a later date?

In summary, a total implementation plan for each business model should be completed to assist in the Board's decision making process.

***History*:** The California Legislature established the Annuitants' Health Care Coverage Fund (AHCCF) in 1988. At that time the state legislature expressed concern over the practice of funding health care costs on an annual "pay-as-you-go" basis. The legislature's concern over the lack of pre-funding retiree health benefits resulted in the enactment of AB 1140 in 1988. The legislation established the Annuitants' Health Care Coverage Fund (AHCCF) to pre-fund health care coverage for annuitants covered by the Public Employees' Medical and Hospital Care Act (PEMHCA). The CalPERS Board was charged with calculating employer contributions and administering the fund. However, the Legislature has never appropriated the funds to allow CalPERS to comply with this charge.

Discussion:

Overview: The GASB is a non-profit organization that formulates accounting standards for state and local governments. GASB standards are not law but are accounting principles that improve the relevance of financial reporting.

GASB issued these two accounting standards in final form in 2004. GASB statement No. 43, entitled "Reporting for Retirement Benefit **Plans** Other Than Pensions", applies to CalPERS while GASB statement No. 45, entitled "Reporting by **Employers** for Other Post Employment Benefits (OPEB)" applies to all governmental employers.

Under GASB 43, CalPERS is not required to report the unfunded liability for retiree health benefits unless we begin accepting employers' contributions towards pre-funding their future retirees' health costs. If CalPERS does not accept such pre-funding contributions, then there may be slight changes in the reporting of the PEMHCA fund in CalPERS financial statements, but we do not have to perform an actuarial valuation to determine total PEMHCA actuarial liabilities and these actuarial liabilities do not need to be disclosed in CalPERS financial statements. If CalPERS does start to receive employer contributions to pre-fund retiree health, CalPERS must start reporting the unfunded liability for retiree health under GASB 43 in financial statements for periods beginning after December 15, 2005, i.e., for fiscal year July 1, 2006 through June 30, 2007.

Under GASB 45, all government employers must report their unfunded liability or produce financial statements that are not constructed under generally accepted accounting principles (GAAP) thereby receiving qualified auditor opinions. The commencement date for required disclosures for employers under GASB 45 depends on the size of the employer. Larger employers must start recognizing their liability for financial reporting periods beginning after December 15, 2006, i.e., for fiscal year July 1, 2007 through June 30, 2008.

CalPERS' Alternative Responses: CalPERS' alternative responses to the new accounting standards are as follows:

1. ***Data Only Model (Minimum Response)*** - Provide necessary demographic data only to allow employers to have outside actuaries perform the necessary liability calculations

   Pros: Little additional work and expense for CalPERS.

   Cons: May be construed as non-customer oriented.

2. ***Actuarial Valuation Only Model*** - Perform post-retirement health benefit actuarial valuations only and not accept pre-funding contributions from employers, i.e., tell employers what their liabilities are and what their annual contributions should be, but employers will decide where (outside of CalPERS) to place and invest those contributions.

   Pros:
   - Would provide CalPERS employer customers a valuable service at a relatively inexpensive price.
   - Would help in encouraging employers to pre-fund retiree health care and so enhance the benefit security for current and future retirees.

   Cons:
   - Would require substantial effort and budget dollars for CalPERS to build the computer system(s) and potential new actuarial staff needed to accomplish this task.

3. ***Full Service Model*** – Fully engage in the business of pre-funding retiree medical costs. That is, CalPERS would perform the actuarial valuations and accept pre-funding contributions.

   Pros:
   - Reduces projected future employers' long-term contributions through the addition of investment income. Health benefits are currently funded through employer, employee, and retiree contributions on an annual "pay-as-you-go" basis. This produces no interest to help offset current and future employer costs. By pre-funding, there is the potential to ultimately have 80% or more of the ultimate costs provided by investment income rather than directly from the budget of employers.

- Enhances benefit security for retirees (CalPERS Strategic Goal I – Be a champion for retirement and health security).
- Enhances customer service to employers who desire to pre-fund retiree medical benefits.
- Employers' credit ratings may be affected if they don't pre-fund; making it difficult to issue bonds, etc.

Cons:
- Requires start-up expenditure by CalPERS in times of limited funds.
- Employers may not have the money to pre-fund –see survey at the end of this issue paper.

Note that accepting the contributions at CalPERS without doing the actuarial valuations is not a plausible alternative because under GASB 43, by taking the funds, CalPERS would be required to place the liabilities on our financial statements. So, we would have to do the actuarial work in-house or contract with an outside actuarial firm to perform the annual valuations.

CalPERS Estimated Administrative Cost for the Alternatives:

The chart below summarizes the incremental costs of each of the business models:

	Data Only	Actuarial Valuations Only	Full Program
Total One-Time Costs	$28,332	$1,039,147	$2,254,147
Annual On-Going Costs	$0	$1,856,780	$2,407,654
Total Costs (thru Year 1)	$28,332	$2,895,927	$4,661,801

Note**:** The on-going annual costs presented here are not the full cost of each model. They represent only the incremental increase in administrative costs to CalPERS. In other words, these annual costs do not include the direct cost of existing staff, a proportionate share of indirect costs such as license fees and maintenance costs of existing systems, or any overhead allocations that would be charged to the new fund.

The Data Only Model impacts CalPERS administrative costs the least amount of the four models. The initial cost is approximately $28,000, which is mainly for writing the computer programs to extract data from systems. Once the extract process is established, the on-going work effort to extract and transmit data is minimal and could be done with existing resources.

The Full Program Model, of course, imposes the greatest incremental increase in costs of approximately $2.4 million. The highest on-going expense in this model could be the cost of actuaries, which assumes CalPERS is indeed able to hire the number of staff recommended. If CalPERS chooses this model, management may want to consider outsourcing the valuations. The project team was unable to obtain an estimate for outsourcing the valuations because a definitive set of requirements does not yet exist.

CalPERS could offset the administrative costs of the fund by either charging employers a fee for their valuations or increasing the fee charged to employers administering the PEMHCA program. Lastly, CalPERS could spread implementation costs over time by implementing the pre-funding program in stages.

Employer Views:

The State: The State Controller's Office has informed CalPERS staff that they intend to have the GASB 45 liability for the State computed and placed into the State's financial statement. CalPERS is working with the Controller's Office and the State Department of Finance in seeking funds in next year's budget for the Controller's office to have a CalPERS contracting actuarial firm perform an initial actuarial liability calculation for the State.

Local Governments**:** In May 2002, CalPERS, through the California League of Cities, conducted a survey of local governments to seek their views on pre-funding retiree medical costs. At the request of the CalPERS Board, this survey was recently repeated. The results of both surveys are contained in Attachment 1 and Attachment 2.

V. STRATEGIC PLAN:

This item is not a specific product of the Strategic or Annual Plans but is part of the regular and ongoing workload of the Actuarial & Employer Services Division.

VI. RESULTS/COSTS:

The chart below summarizes the incremental costs of each of the business models:

	Data Only	Actuarial Valuations Only	Full Program
Total One-Time Costs	$28,332	$1,039,147	$2,254,147
Annual On-Going Costs	$0	$1,856,780	$2,407,654
Total Costs (thru Year 1)	$28,332	$2,895,927	$4,661,801

Ron Seeling, Chief Actuary
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Attachments